**COMMONWEALTH OF MASSACHUSETTS**
**DEPARTMENT OF TELECOMMUNICATIONS AND ENERGY**

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| **Bay State Gas Company** | ) | **D.T.E. 05-27** |

**REPLY BRIEF OF THE**

**MASSACHUSETTS DIVISION OF ENERGY RESOURCES**


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## I. INTRODUCTION

Pursuant to the procedural schedule in this proceeding, the Massachusetts Division of Energy Resources (DOER) hereby submits it Reply Brief to the Initial Brief of the applicant, Bay State Gas Company (Bay State or Company). DOER believes that its Initial Brief has largely addressed the contentions made by Bay State with respect to the issues raised by DOER. We have limited this reply to a few salient points.

First, Bay State's attack of DOER's alternative performance based rate (PBR) proposal is simply a distraction from the infirmities in its own proposal. DOER has crafted a solution to the failure of the Company to apply Department precedent to the facts of this case so as to preserve and not distort the benefits of a PBR. As will be described more fully below, the DOER alternative is consistent with Department precedent and cures the infirmities of the Company proposal. Second, the primary distortion of the Company's proposal is the steel infrastructure replacement (SIR) program. The theory posed by Bay State treats the SIR program as equivalent to an exogenous factor in the PBR mechanism, yet they acknowledge that these costs do not fit the Department precedent for such factors. Finally, while DOER and the Company seem to agree on the purpose of the earnings sharing mechanism (ESM) (see Bay State Initial Brief at 168), only DOER has proposed an ESM that will meet those purposes.

## II. DOER'S TWO X-FACTOR PROPOSAL IS CONSISTENT WITH DEPARTMENT PRECEDENT

In its Initial Brief, Bay State implies that DOER has presented an ill- contrived alternative proposal that changed between the filing of Dr. Pereira's direct testimony and his oral surrebuttal and then again in DOER's Initial Brief. Putting aside whether that has any relevance other than procedural due process, it is not true and attempts to undermine the credibility and expertise of the witness and the agency as well as distract the Department from the substance of the proposal. The cross examination of Dr. Pereira on both his direct and surrebuttal testimony, including his Exhibit No. DOER-AEP-2, simply provides further explanation of the position clearly stated in his direct testimony. The formulas presented in DOER-AEP-2 lay out the underlying calculations of the formula provided in his direct testimony, Exhibit No. DOER 1, at page 7.

Dr. Pereira's testimony and the agency's position has been consistently the same. DOER has proposed two X-factors for one PBR: one for the O&M costs and one for the capital costs. The effect of DOER's proposal is a rate freeze on capital costs since, as admitted by Dr. Kaufmann, the total cost study did not support the application of the Boston Gas PBR formula to all Bay State costs. We will not repeat our arguments here and rely on DOER's Initial Brief in this regard.

Some of the strongest evidence in the record that Bay State might not have managed its capital costs as well as its O&M costs is the analysis by Dr. Pereira in Exhibit DTE-DOER-1-6. Bay State contends that these comparisons are "meaningless". Brief, at 180. Bay State criticizes his analysis because it allegedly does not accurately present the Company's efficiency gains during the period of the rate freeze.[1] The more favorable analysis provided by Dr. Kaufman is a comparison of the Company's performance to itself. But that is not the proper comparison. The X factor is dependent on a comparison of the Company's performance to the industry, not to itself. That is the comparison made by Dr. Pereira.

Bay State has also distorted DOER's position in its statement that "DOER apparently believes that a comprehensive PBR plan can only be adopted for a Company if there is a total cost study demonstrating 'superior cost performance' for both capital and O&M." Bay State Initial Brief, at 177. However, the cite relied upon by Bay State in making this statement does not support it and it is not DOER's position. What DOER has said is that in order to apply the components of the Boston Gas PBR, Bay State's facts must fit the facts of that case, i.e. total cost study with indication of a superior cost performance in all costs categories. Bay State did not show that. Therefore, the components cannot be identical. The consumer dividend should be different and, indeed, the X factor as a whole. DOER does not contend that a total cost PBR is required by Department precedent, but we do contend that the PBR adopted must be suited to the costs to which it will apply and the performance of the utility in managing those costs. Bay State is correct in stating that "[T]he DOER proposals are not consistent with any PBR plan approved by the Department." Brief at 179. But neither is theirs. The issue is which is a closer fit.

[1] The Company also criticizes Dr. Pereira's analysis because the time periods compared do not correspond to the period of the rate freeze. That information, however, was not provided by the Company. See, Response to DOER 1-10.

## III. THE SIR PROGRAM IS NOT SUPPORTED BY THE RECORD AND IS INCONSISTENT WITH THE DEPARTMENT'S PBR PRECEDENT

Bay State contends that the SIR is appropriate and consistent with the PBR price cap because the index "will not accommodate the rapidly increasing expenditures of the SIR program." Brief, at 171. We disagree. First, the Company has not shown that these costs are different than other capital costs. The cost of maintaining its pipeline is a predictable and foreseeable cost of a gas distribution company. Second, in both the Boston Gas case and Docket DPU 94-158, the Department has already addressed how to manage the circumstances of separate targeted rate recovery, such as the meter replacement example in the Company's brief. Id. In both cases, the Department acknowledged that there may be circumstances where the price cap index does not adequately allow for recovery of costs outside of the control of the company. In discussing so-called exogenous cost recovery, the Department has stated that such costs are ones "that the company cannot anticipate prior to entering into long-term PBR plans." Docket No. 03-40, at p. 490. The Department proceeded to list examples of such costs, e.g. tax law changes, accounting changes and regulatory, judicial and legislative changes. Id. Dr. Kaufmann has presented a similar definition Tr. 1452. The SIR costs do not fit this definition. Essentially, Bay State is seeking treatment of these costs as exogenous to the PBR, yet because they do not fit the definition, they have proposed an alternative. Bay State should not be allowed to circumvent the Department's clearly enunciated accommodation of exogenous costs.

## IV. BAY STATE’S ESM DOES NOT MEET THE GOAL OF SHARING BENEFITS WITH CUSTOMERS

As stated above, DOER agrees with Bay State that one of the purposes of the earnings sharing mechanism (ESM) is to allow customers to share in the benefits of efficiency gains made by the company under the PBR plan. DOER has proposed modifications to the proposed ESM to increase the likelihood that such sharing will actually occur. As pointed out by Dr. Pereira, no ESM adopted in this Commonwealth has yet to yield sharing of earnings with customers. Tr. 2887.

Bay State’s first complaint with Dr. Pereira’s proposal for a sharing of 75% customers and 25% shareholders in the 50-200 basis point range is that it would take away the incentive of the Company to make upfront investments that would reduce earnings in the near term but yield later benefits to customers, but not shareholders. This point goes to the term of the ESM, not the design. Under Dr. Pereira’s proposal, in the out years, as the efficiency gains increase, the shareholders would receive a greater percentage (75%). [2] Consequently, DOER’s proposed ESM does meet the dual goals of creating efficiency gains and sharing of those gains with customers.

## V. CONCLUSION

Thus, the alternative PBR proposed by DOER is a significant improvement on the Company’s proposal. While the Company’s cost study fails to support its proposal for a

[2] Bay State challenges DOER’s contention that the 400 basis point ESM is the richest among the jurisdictions surveyed by DOER by pointing to the Berkshire Gas case where that company has no ESM and, therefore, is not required to do any sharing. But that case shows the importance of the term of a PBR. Berkshire only has a three year PBR. The longer the PBR, the more opportunity there is for significant savings. Tr. 744. The shortness of the Berkshire PBR reduces the need for an ESM.

full application of the Boston Gas PBR to Bay State, the evidence presented by Dr. Pereira demonstrates that a PBR with two X-factors is a fair alternative to the Company's proposal and is consistent with the Department's objectives of economic efficiency, cost control, lower rates, and reduced administrative burden.   Furthermore, the Company's attempt to separate out its SIR Program is inconsistent with Department precedent and should be rejected.  Finally, the proposed ESM must be modified to increase the likelihood that such sharing will actually occur.

Respectfully submitted,

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